

1957

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Wilbert H. Schowtzer

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Recommended Citation

Haskins & Sells Selected Papers, 1957, p. 338-346

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An Introduction to Accountants' Legal Responsibility

BY WILBERT H. SCHWOTZER

Principal, Pittsburgh Office

*Presented before the Pittsburgh Chapter, Pennsylvania
Institute of Certified Public Accountants – September 1957*

Why should you or I be concerned about the legal responsibility of an accountant? Because we do have responsibilities – legal, as well as ethical. Where there is responsibility, there is the possibility of attack by those who think they have been wronged. It behooves you and me to protect ourselves as well as we can from attack – especially from successful attack. The easiest way to protect ourselves is to avoid responsibility – to go out of business. Of course, a better solution, and really the only solution, is to accept our professional responsibility, render service to clients, but study carefully the legal aspects of our work.

At this point let me place a disclaimer in the record. I am a CPA, not a lawyer. I do not profess the ability to interpret the law. When I talk about negligence or fraud, for example, I am not trying to define the terms. In fact, as accountants we should not worry a great deal about the distinction. A little negligence is too much. As accountants we should let the records of court and disciplinary proceedings serve as case studies which will provide us with examples of the kind of trouble that we can get into.

In 1954 the American Institute of Accountants published a book entitled *Accountants' Legal Responsibility* by Saul Levy. This book is "must" reading for every accounting practitioner – the staff accountant as well as the principals of the firm. And it is fascinating reading, too. The book contains about 200 pages of excerpts from court opinions in cases involving accountants. The excerpts give some dramatic examples with which you can compare your own practice. As you read the cases, you may stop in the middle of a sentence as you recall a situation in your own experience not unlike the one you are reading about.

How does Saul Levy classify our legal responsibilities?

LIABILITY TO CLIENTS

He speaks of liability to clients. "In this branch of the subject, . . . the claims are usually based upon the failure of the auditor to discover defalcations or other similar irregularities."¹ Do not assume that you have educated each of your clients sufficiently, that each of them is a good fellow,

¹ Levy, *Accountants' Legal Responsibility*, p. 12.

and that none of them would take you to court. For a surety company, which has made good a loss under a fidelity bond, becomes subrogated to the rights of the client. The surety company may not be so friendly and may sue you.

In a case involving irregularities the questions are these:²

- What was the nature and scope of the engagement? This question raises the practical question: How do we best define the terms of our engagement?
- Did the accountant exercise appropriate care?
- If appropriate care was not exercised, would its exercise have resulted in discovery of the irregularities?

LIABILITY TO CLIENTS — PENALTIES

A natural question to ask is: What is the penalty if I am found guilty of negligence?

First, let me say that whether or not you are found guilty, your reputation may be damaged. This is a very good reason to avoid involvement in a law suit.

As to damages,³ a court may award damages to a client if it finds that the accountant was negligent in his performance of the work. Maybe only the accountant's fee is at stake.

On the other hand, a fantastic award for damages may be allowed.⁴ Consider a situation in which the accountant, through negligence, fails to discover a defalcation. For what amount of damages is the accountant liable? For the loss incurred to the date of his examination? Or for that amount plus losses incurred after that date?

In one case — the National Surety Corp. case⁵ — a shortage of \$123,000 existed at the date of the accountants' first audit. Four years later, when the cashier confessed, the shortage was \$329,000. The plaintiff claimed that if the accountants had discovered and reported the misappropriations, the employment of the cashier would not have been continued and the subsequent losses would not have been sustained. The trial court concluded that the plaintiff failed to make out a case for submission to the jury. But the appellate court said that the plaintiff had established a prima facie case and that it was for the jury to decide.

Certain of the words of the Appellate Division are interesting:

² American Institute of Certified Public Accountants, Accountants' Legal Responsibility Course Manual and Discussion Guide, p. 73 (1956). In subsequent footnotes referred to as Manual.

³ See Manual, p. 44.

⁴ Craig v. Anyon.

⁵ National Surety Corp. v. Lybrand.

We are, therefore, not prepared to admit that accountants are immune from the consequences of their negligence because those who employ them have conducted their own business negligently. . . . Accountants, as we know, are commonly employed for the very purpose of detecting defalcations which the employer's negligence has made possible.

Many of these cases make good staff training material. This one, the National Surety Corp. case, makes a good case study of the kiting of checks.

LIABILITY TO THIRD PARTIES AT COMMON LAW

In his book, Saul Levy mentions, as the second broad category, liability to third parties at common law.

There are many fine legal points involved in connection with such liability. I shall not attempt to differentiate them. May I state only some very general rules: ⁶

- Except in certain limited cases, the accountant is not liable to a third party for negligence.
- A third party, to succeed, must prove fraud and must prove that he has been damaged by the fraud.

You are no doubt familiar with the Ultramares case. Saul Levy describes it as "undoubtedly the leading American case dealing with the legal responsibility of accountants." ⁷ May I quote only two sentences from the opinion of Justice Cardozo: ⁸

. . . we are to bear in mind the principle . . . that negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross.

The Ultramares case, too, makes good material for staff training. The facts of the case point up the necessity for diligent supervision and review and the rôle of working papers in a court proceeding, among other matters.

LIABILITY TO THIRD PARTIES BY STATUTE

The third broad category of liability is liability to third parties by statute. The most important statute affecting accountants is the Federal

⁶ Cases where the accountant's services are for the primary benefit of the third party. See Manual, p. 127, and C.I.T. Financial Corporation case.

⁷ Levy, p. 30.

⁸ Appears on p. 190 of Levy.

Securities Act of 1933. The Act "regulates the offering of securities for sale to the public through the use of the mails or in interstate commerce."⁹ It provides for the filing of a registration statement and a review of that statement by the Securities and Exchange Commission before the securities are offered for sale. There must be included certified financial statements of the issuer of the securities. The Act sets up a greater degree of liability on the part of the accountant than the common law established. Remember that the common law says generally that the accountant is liable to third parties only for fraud, not for negligence. Under the Federal Securities Act the accountant is liable for negligence as well as fraud to third parties, namely, the buyers of the securities which were sold on the strength of the registration statement.⁹

You, a small practitioner, may not be concerned about the Federal Securities Act, for you have no clients who plan to make a public offering of their securities. But you should be aware of this possibility: that gradually the number of your client's stockholders increases, that your client is then acquired by another corporation in exchange for stock, and that a registration statement is filed in connection with the issuance of the stock. In such a case the certified financial statements of the acquired corporation, your client, are included in the registration statement, covering at least a five-year period. Let us assume that in a certificate you say that you have not observed physical inventories but that you have satisfied yourself by means of other auditing procedures. Two years hence your certificate is included in a registration statement filed with the SEC. You should be forewarned that the SEC may require of you a satisfactory explanation of your other procedures. Not only is the SEC aware of our American Institute publications but also they do not hesitate to refer to them in their communications.

LIABILITY TO THIRD PARTIES — PENALTIES

What is the extent of our liability to third parties? Here the amount of your fee is not pertinent, for you do not have a contract with the third party. But your liability as an accountant can amount to many times the fee. Judge Ryan, in the recent C.I.T. Financial Corporation case, expresses it well in his charge to the jury:

The measure of damages due . . . is indemnity for the actual loss sustained as the direct result of the wrong.

The measure of the liability is about the same under both the common law and the statutory law.

⁹ See Levy, p. 45.

DISCIPLINARY PROCEEDINGS

Another category of legal responsibility is that of disciplinary proceedings. This category does not have to do directly with the common law or statutory law. An adversary may not be able to prove that he sustained damages as a result of the accountant's negligence or fraud. He may be a third party who cannot sue for recovery of a fee. Instead he may file a complaint with a disciplinary body. Thus in our discussion of legal responsibility we should mention these disciplinary proceedings.

Let me name the rules which have been established by bodies which have disciplinary powers:

- The by-laws of the American Institute of Certified Public Accountants contain certain disciplinary clauses, and supplementing these are the Rules of Professional Conduct.
- The Pennsylvania Institute of CPAs has its Canons of Professional Ethics.
- Effective January 1, 1955, the Pennsylvania State Board of Examiners of Public Accountants established Rules Pertaining to Unprofessional Conduct. And under the Pennsylvania CPA Law the Board has the power to censure or reprimand a CPA or to revoke or suspend his certificate when he has been found guilty of unprofessional conduct as defined in the rules.
- The United States Treasury Department's Circular 230 contains rules and regulations relating to practice before the Treasury Department. One of the rules¹⁰ provides that each enrolled agent shall "observe the ethical standards of the accounting profession."
- The Securities and Exchange Commission has adopted Rules of Practice. One of the rules¹¹ provides, among other things, that the Commission may deny the privilege of appearing or practicing before it to any person who is found to have "engaged in unethical or improper professional conduct."

GENERALLY ACCEPTED AUDITING STANDARDS

In a discussion of accountants' legal responsibility we must talk about the accounting literature and our standards of practice. Saul Levy says it this way:¹²

As members of a skilled profession, it is the right of every accountant

¹⁰ Sec. 10.2(z).

¹¹ Rule II (e).

¹² Levy, p. 5.

to be judged by the standards of the accounting profession. Correlatively, it is the duty of the accountant to establish and clarify these standards, not only for the public but for themselves. Otherwise, standards not of their own making will be imposed upon them.

Levy also says: ¹³

If the framework (of professional standards and criteria) is not constructed by the profession itself, it will be rudely fashioned by juries of laymen out of the unfortunate material presented in the extreme situations which are occasionally litigated.

These words emphasize the importance of development of standards by the profession, the importance of adherence to the standards by you and me as practitioners, and the importance of education of the layman as to the meaning of those standards.

Have you ever asked a friend about his understanding of the purpose of an audit? Chances are, even in this era of sophistication, that he would answer, "To uncover shortages." It may be that fellow who serves on the jury.

An interesting case having to do with the description of an audit was the Maryland Casualty Co. case. ¹⁴ The City of Flint had prepared "specifications for audit" for the year ended June 30, 1932. The specifications said:

The City of Flint, Michigan, is requesting bids for a complete audit of the transactions of its various boards, departments and offices on a monthly basis . . .

1. The examination shall be a complete monthly audit.

The defendant accountant submitted a bid which read in part:

We are submitting herewith our sealed bid on the audit of the books and records of the various departments of the City of Flint, Michigan, . . . in accordance with specifications issued by you. . . .

After the City Treasurer was found to have embezzled about \$16,000, the surety companies, who had become subrogated to the rights of the City, sued the accountant.

These are some of the words of the court:

Some of the accountants here testifying have said that this contract and specifications required a cash audit. Some have said it required a balance sheet audit. Some have said it required a combination of a cash and balance sheet audit, and some others have said that it required a detailed audit.

¹³ Levy, p. 80.

¹⁴ Maryland Casualty Company v. Cook.

In the first place, the Director of Finance for the City of Flint in drawing these specifications and drawing this contract had no knowledge of technical auditing terms.

I think it is high time for accountants to know that if they want a particular contract which they enter into to be measured in the technical terms of a cash audit, or a balance sheet audit, or a detailed audit, they should insist that their contract and the specifications which they agree to comply with in their contract should plainly state the facts.

So I interpret this contract with its specifications according to the plain language used.

Let me add that the accountant was found to have been negligent in his work and that the surety companies were awarded damages to the extent of their losses plus certain costs and interest.

This case illustrates the advisability of educating our clients and the public, of having a clear understanding with the client, using technical terms which can be defined, and, most of all, of doing good work. Of course, if we use technical terms, our safety depends upon the extent to which they are generally accepted and defined in the accounting literature.

Let me mention one instance in which one of our professional standards has been adopted in effect by a governmental body. I have already mentioned the Pennsylvania State Board's Rules Pertaining to Unprofessional Conduct. Rule No. 2 is headed "Expressing Opinions." It reads, in part:

In expressing an opinion on representations in financial statements which he has examined, a certified public accountant shall . . . in the absence of an unqualified opinion . . . , (1) express a qualified opinion, or (2) state that no opinion is expressed regarding the statements as a whole, or (3) indicate that the statements have been prepared from the books without audit.

You may recognize this rule as an adaptation of one of our generally accepted standards of reporting.

Recently I saw a set of financial statements on the cover of which appeared the name of the company, the description "Financial Statements, and Consolidation for the Year Ended December 31, 1956," and the name of a CPA firm. Inside the cover on the watermarked paper of the firm was a set of consolidating financial statements and nothing else. There was no opinion, qualified or unqualified, and no disclaimer, nor was there an indication that the statements were unaudited. I fear that financial statements have been presented in such form by CPAs in more than one case. Yet a CPA putting out such a report, if I may call it a report, is subject

to reprimand by the Board of Examiners. And it is within the Board's power to revoke the certificate of the CPA.

WORKING PAPERS

A few words about working papers.

During the process of writing a report and preparing working papers, you should ask yourself a number of questions:

- Is each fact or opinion in the financial statements and the report substantiated by the working papers?

The papers should show that your work was adequate for the expression of your opinion. As an example, the balance sheet shows a Federal income tax liability of \$25,000. Certainly there should be computations in your working papers supporting that amount.

- Are there any apparent inconsistencies in your working papers or evidences that you changed your mind about an important matter?

For example, did your first computation show a Federal income tax liability of \$50,000? If so, you should prepare a memorandum explaining the reasons for the change in your computation. Or the circumstances may be such that you are justified in destroying your original computation.

- Does each working paper serve a purpose in substantiating a fact or opinion in the financial statements or report?

In the first place, superfluous working papers make the reviewer's task difficult and may even cause him to overlook an important matter. A second point is that a great number of superfluous working papers reflects unfavorably upon the proficiency of the accountant. Although an adversary may have difficulty in proving such a point in a legal proceeding, an excessive number of unnecessary papers may have its effect on the thinking of a jury. A third point, and probably the most important point relating to superfluous working papers, is that such papers give an adversary many opportunities to pick flaws, to ask embarrassing and damaging questions; they give him ammunition.

I said that, during the process of writing a report and preparing working papers, you should ask yourself these questions. Of course, each report and each set of working papers should be reviewed. And the reviewer should ask himself the same questions.

How are these questions related to accountants' legal responsibility? The working papers furnish evidence that your examination was made in accordance with generally accepted auditing standards, and accordingly

included such tests of the accounting records and such other auditing procedures as you considered necessary in the circumstance. And the working papers give your adversary a chance to find flaws in your work.

CONCLUSION

I have barely scratched the surface of each of the points that I have mentioned. I have not even mentioned a number of points such as:

Accountants' liability insurance.

Responsibility for tax work.

Fact vs. opinion in our reports.

You and I as practitioners should be aware of the problems involved. Each staff member, even the newest junior assistant, should be indoctrinated with the working aspects of our legal responsibility. For your staff assistant, this very minute, may be exposing you to liability.

In conclusion, let me list a number of matters which we should give attention to in each engagement. These are not all the items to be considered, but they are some of our safeguards against disaster. You will recognize some of them as certain of our auditing standards:

- Have a clear understanding with the client concerning the nature of the engagement.
- Employ and assign to the engagement persons who are adequately trained and proficient.
- Plan the work adequately and properly; supervise the assistants, if any.
- Make a proper study and evaluation of the existing internal control.
- Observe the standards of reporting.
- Provide for the review of the report and working papers by a qualified person, and if possible provide for a concurring review of the report by a qualified person who has not otherwise worked on the engagement.
- Review the report with the client, for the financial statements with the footnotes are his representations.
- If I have missed a point, let this one suffice. Do good work.